Office of Chief Counsel
Internal Revenue Service

memorandum

CC:WR:NCA:SF:TL-N-7277-99
MTRobus

date: January 13, 2000

to: District Director, Northern California District
Attn: Cindy Kausek, Team Coordinator EG 1825

from: District Counsel, Northern California District, San Francisco

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subject: **Agreement between [redacted] and [redacted]**

This is in response to your memo dated November 29, 1999, requesting advice on an agreement between [redacted] (hereinafter "the taxpayer" or "[redacted]") and [redacted] (hereinafter "[redacted]"). In your memo you posed the following issues:

ISSUES

1. Is this agreement typical for franchise rights to be (created) transferred?

2. What is actually being sold? It appears from the agreement that [redacted] (hereinafter "[redacted]") is able to access [redacted] including its technological advantage over its competitors. Are these franchise rights?

3. Has the "all events test" been met upon execution of the contract, or is the taxpayer correct in deferring recognition of the money received and recognizing it on a pro-rata basis over [redacted] years, the probable life of the agreement?

4. In which year does the transaction belong given the discrepancy between the date of execution and the date of receipt of the money?

CONCLUSIONS

1. Based on the analysis that follows, we believe that the agreement in question involves the transfer of a franchise, as that term is defined in the Internal Revenue Code.

2. We agree with your conclusion that [redacted] is, as a result of the agreement, able to access both the taxpayer's global network and technological advantage over its competitors. Pursuant to the agreement, the taxpayer is allowing [redacted] the right to use the taxpayer's name as part of the name of a wholly-owned subsidiary company that [redacted] will form in [redacted] which company will implement sales and operations with the taxpayer's global network with respect to [redacted], consolidation services and the handling and delivery of [redacted] which originate or terminate [redacted].

3 and 4. We conclude, subject to the condition precedent stated in ¶ 14 of the agreement being accomplished, that the "all events test" has been met upon execution of the contract on [redacted]. The taxpayer is not correct in deferring recognition of the money received and recognizing it on a pro-rata basis over [redacted] years, beginning in the taxable year ending [redacted]. For the reasons stated below, an adjustment under I.R.C. § 481(a) for the deferred income should be made in the taxable year ending [redacted], which is currently under examination.

FACTS

On [redacted], the taxpayer and [redacted] signed an agreement entitled as follows:

[redacted]

The agreement, a copy of which is attached, was signed on [redacted], by the taxpayer and [redacted] "...with respect to the promotion and sale of [redacted], consolidation services and the handling and delivery of [redacted] which originate or terminate within [redacted]." The terms of the agreement include, in relevant part, the following:

1. [redacted]

a. Prior to, on or promptly after the Closing Date, [redacted] shall form or acquire a sales and customer service company in [redacted] under the name [redacted], which will work as the sub-agent of [redacted] to implement sales and operation with [redacted] networks.

b. [redacted] shall be wholly-owned and financed by [redacted]

and or its affiliated companies.

c. As part of the [redacted] of affiliates and agents, [redacted] in [redacted] shall be responsible for pricing, the establishment and enforcement of client requirements, customer services and sales coordination.

....

g. All export [redacted] bills issued by [redacted] for [redacted] shall read "[redacted]."

h. [redacted] agrees not to appoint any person other than [redacted] to represent the [redacted] in [redacted] so long as this Agreement is in effect. [redacted] shall pay [redacted] the sum of [redacted] Dollars (US$[redacted]) as a franchise fee. **The Franchise Fee shall be paid to [redacted] in its entirety upon the execution of this Agreement.** [Emphasis added.]

The agreement includes other provisions such as the taxpayer's right to place an employee into the [redacted] office in [redacted] "to enhance sales presentation, logistics and client services." (¶ 1.j.) The taxpayer also has the right to purchase up to [redacted]% of the stock of [redacted] should a key person leave, and [redacted] can renegotiate certain provisions should the taxpayer's current CEO leave [redacted] (¶¶ 2. and 3.) The parties are authorized to represent each other in the sale of [redacted] and maintain offices in their respective countries engaged in the sale of [redacted]. (¶ 4.a. and b.) The agreement also covers tariffs, "house paper," compensation for each party's services under the agreement, handling of consignments, reports, liability insurance, the wire transfer of payments due to each party, advertising, records, and other operational details. (¶¶ 5. through 13.)

Paragraph 14 of the agreement is entitled "[redacted]," and states, "[redacted]." Please obtain a copy of that agreement or additional facts, so we can determine whether the condition precedent was fulfilled.

The agreement contains at Paragraph 16 an "Applicable Law" clause stating that, "[T]his agreement shall be interpreted in

accordance with the law of the United States of America." Paragraph 17 states that the initial term of the agreement shall be [redacted] years with an option to extend the term for an additional [redacted] years at [redacted]'s election. According to ¶ 20, the assignment of the agreement is prohibited without the prior written consent of the other party.

Exhibit A attached to the agreement contains the terms of the compensation for the services rendered under the agreement. Each party is obligated to pay the other a certain percentage of net profit. The taxpayer is obligated to pay [redacted] with respect to those ships originating in the U.S. or in the taxpayer's global network which are destined for [redacted] and [redacted] is likewise obligated with respect to shipments originating in [redacted] and destined for the U.S. or the taxpayer's global network. The taxpayer's global network is defined on Exhibit C to the agreement as "...legal operating divisions of [redacted] and includes but is not limited to offices in the countries listed below. [redacted] guarantees payment for all wholly owned offices." Thereafter follows a list of countries beginning with [redacted] and ending with [redacted].

Tax Consequences of the Agreement According to the Taxpayer

The taxpayer claims to have received the $[redacted] cash in [redacted]. According to the taxpayer, the money was sitting in [redacted] for a while. The taxpayer then booked the $[redacted] into its General Journal as an entry taking the money out of an inter-company account with a [redacted] subsidiary in [redacted] and crediting it as deferred income to the domestic parent on [redacted]. The taxpayer reported [redacted] months ([redacted] (date of the agreement) to [redacted] (end of the fiscal year) of the $[redacted] in income on its return ending [redacted].

DISCUSSION

The Franchise Agreement

Under the Internal Revenue Code, the analysis of the transaction in question must determine first whether a transfer of a franchise is involved and, second, if such a transfer is involved, whether the taxpayer maintained the requisite "power, right, or continuing interest with respect to the subject matter of the franchise." Section 1253(b)(1) defines "franchise" as "includ[ing] an agreement which gives one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities within a specified area." The agreement between the taxpayer and [redacted] fits within that definition. Pursuant to the agreement, the taxpayer granted [redacted] the

exclusive right within [redacted] to provide services with regard to [redacted] as part of the taxpayer's global network of offices. [redacted] was also given the right to incorporate the taxpayer's name in the name of a wholly-owned subsidiary, i.e., [redacted] and to represent itself as part of the [redacted] of affiliates and agents. Further, all export [redacted] bills issued by [redacted] were to read, "[redacted]." The agreement provides for a sharing of the net profit resulting from the services provided.

Turning to the second determination of whether the taxpayer maintained a "significant power, right, or continuing interest with respect to the subject matter of the franchise," Section 1253(b)(2) provides:

> Significant power, right, or continuing interest.-- The term "significant power, right, or continuing interest" includes but is not limited to, the following rights with respect to the interest transferred:
>
> (A) A right to disapprove any assignment of such interest, or any part thereof.
>
> (B) A right to terminate at will.
>
> (C) A right to prescribe the standards of quality of products used or sold, or of services furnished, and of the equipment and facilities used to promote such products or services.
>
> (D) A right to require that the transferee sell or advertise only products or services of the transferor.
>
> (E) A right to require that the transferee purchase substantially all of his supplies and equipment from the transferor.
>
> (F) A right to payments contingent on the productivity, use, or disposition of the subject matter of the interest transferred, if such payments constitute a substantial element under the transfer agreement.

In the agreement, the taxpayer maintained significant rights over the subject matter of the franchise as defined under the Internal Revenue Code. For example, the taxpayer retained the right to disapprove any assignment of the rights and duties under the agreement (Section 1253(b)(2)(A)); the taxpayer has the right to place an employee into the [redacted]

office of [redacted] (Section 1253(b)(2)(C)); and the taxpayer is entitled to compensation under the agreement contingent on the use of the subject matter of the interest transferred, and such payments constitute a substantial element under the agreement (Section 1253(b)(2)(F)). Thus, the agreement falls within the scope of Section 1253(a) since the agreement constitutes a transfer of a franchise and in the agreement, the taxpayer retained significant rights with respect to the subject matter of that franchise. See, e.g., Syncsort Incorporated, et al., v. The United States, 31 Fedcl 545 (Cl. Ct. 1994); Tele-Communications, Inc. v. Commissioner, 95 T.C. 495 (1990), aff'd, 12 F.3d 1005 (10th Cir. 1993); International Multifoods Corporation and Affiliated Companies v. Commissioner, 108 T.C. 25 (1997).

The taxpayer transferred unique intangible assets to [redacted] under the terms of the agreement, including its name, the ability to market services as its agent in [redacted] and the right to be included in the taxpayer's worldwide network including all the technological advantages and benefits associated therewith. Hence, the franchise fee received in connection with the transfer of the franchise that is attributable to the transfer of these assets must be treated as ordinary income for federal income tax purposes pursuant to I.R.C. § 1253(c).

The Franchise Fee

Section 451(a) of the Internal Revenue Code provides that the amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

Section 1.451-1(a) provides that, under an accrual method of accounting, income is includible in gross income when all the events have occurred that fix the right to receive income and the amount of the income can be determined with reasonable accuracy (the "all-events test"). See also §1.446-1(c)(1)(ii)(A). All the events that fix the right to receive income occur when (1) the required performance takes place, (2) payment is due, or (3) payment is made, whichever happens earliest. See Schlude v. Commissioner, 372 U.S. 128, 133 (1963); Rev. Rul. 84-31, 1984-1 C.B. 127. The accrual method does not focus on the time of payment or receipt, but upon the time there is an obligation to pay or a right to receive. See United States v. Hughes Properties, Inc., 476 U.S. 593, 599, 604 (1986); Spring City Foundry Co. v. Commissioner, 292 U.S.

182, 184 (1934). The all events test was judicially devised to measure whether and when an item should be accrued or reported. The all events test was formulated in case law more than 50 years ago and has long been embodied in Treas. Regs. section 1.461-1(a)(2) concerning the deductibility of an expense under an accrual method of accounting.

Here, the taxpayer, [redacted] had performed all that was required of it under the terms of the agreement, and was entitled, therefore to receive the franchise fee on the day of execution of the agreement, i.e., [redacted]. The taxpayer is an accrual-basis taxpayer, filing on a fiscal year basis ending on [redacted]. As indicated above, under the accrual method of accounting, the fee is includible in gross income when all the events have occurred that fix the right to receive income and the amount of the income can be determined with reasonable accuracy. Hence, the fee was includible in the taxpayer's income in the fiscal year ending [redacted]. The taxpayer reported no part of the fee on its [redacted] return, reporting instead, nineteen (19) months of the fee pro rated over ten years on its return for the fiscal year ending [redacted], which year is currently under examination. The [redacted] and [redacted] years were closed agreed sometime ago at the conclusion of the examination. This particular transaction was not disclosed or made known to the revenue agent during the course of the examination of the [redacted] year. The statute of limitations will expire with respect to [redacted] on or about [redacted].

Under I.R.C. § 446, "General Rule for Methods of Accounting," taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes its income in keeping its books. An exception to the general rule is that if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, does clearly reflect income. I.R.C. § 446(b). Here, the taxpayer did not correctly report the franchise fee, resulting in the taxpayer's adopting a change in method of accounting which distorted its income in [redacted] postponing income recognition.

Section 446(b) permits the Commissioner broad discretion to determine whether a particular method of tax accounting clearly reflects income. RLC Industries Co. v. Commissioner, 98 T.C. 457, 491 (1992). That determination is entitled to more than the usual presumption of correctness and "'should not be interfered with unless clearly unlawful.'" Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 532 (1979) (quoting Lucas v. American Code Co., 280 U.S. 445, 449 (1930)). Cf. JFM, Inc.

and Subsidiaries v. Commissioner, T.C. Memo. 1994-239 (a corporation performing services for franchisees of convenience stores had to reflect the income derived from franchise fees in the year of receipt, not in the year contractual performance was complete).

I.R.C. § 481(a) provides that if the method of accounting used in computing income for a taxable year differs from the method used in the preceding taxable year, then the taxpayer must take into account those adjustments necessary solely by reason of the change to prevent the duplication or omission of amounts. The applicable regulations define a change in method of accounting as a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. Treas. Reg. § 1.446-1(e)(2)(ii). Where the Commissioner's determination alters a taxpayer's practice which has resulted in the postponement of income recognition, such determination causes a change in method of accounting. Knight-Ridder Newspapers, Inc. v. United States, 743 F.2d 781, 797-800 (11th Cir. 1984); Wayne Bolt & Nut Co. v. Commissioner, 93 T.C. 500, 510 (1989). The section 481 adjustment is made to prevent the omission or duplication of amounts by reason of the change in tax returns filed after the change in accounting. Cameron Iron Works, Inc. v. United States, 224 Ct. Cl. 17, 25 (1980).

Where, however, a taxpayer entirely avoids the inclusion of income in any year, by, for instance, claiming erroneous deductions, a determination disallowing such deductions does not constitute a change in method of accounting, and section 481 is not available to correct years barred by the statute of limitations. Hamilton Industries, Inc., v. Commissioner, 97 TC 120 (1991) citing Schuster's Express, Inc. v. Commissioner, 66 T.C. 588, 596-597 (1976), affd. without published opinion 562 F.2d 39 (2d Cir. 1977).

In this case, the taxpayer erroneously changed its method of accounting for the franchise fee in [redacted]. Hence an adjustment under I.R.C. § 481(a) is appropriate to avoid the omission of [redacted] income occurring solely by reason of an accounting method change in [redacted]. Section 481 permits the Commissioner to include in the required adjustment, those amounts attributable to taxable years with respect to which assessment is barred by the statute of limitations. Graff Chevrolet Co. v. Campbell, 343 F.2d 568, 572 (5th Cir. 1965); Superior Coach of Florida, Inc. v. Commissioner, 80 T.C. 895, 912 (1983).

According to Rev. Proc. 97-27, 1997-21 I.R.B. 11, which

modified and superseded Rev. Proc. 92-20, 1992-1 C.B. 685, section 2.07, "methods of accounting should clearly reflect income on a continuing basis, and the Service exercises its discretion under §§ 446(e) and 481(c) in a manner that generally minimizes distortions of income across taxable years and on an annual basis." And, under Section 2.10, "Section 446(b) and § 1.446-1(b)(1) provide that if a taxpayer does not regularly employ a method of accounting that clearly reflects its income, the computation of taxable income must be made in a manner that, in the opinion of the Commissioner, does clearly reflect income. If a taxpayer under examination is not eligible to change an accounting method under this revenue procedure, the change may be made by the district director. A change resulting in a positive § 481(a) adjustment will ordinarily be made in the earliest taxable year under examination with a one-year § 481(a) adjustment period."

Here, it is our recommendation that the revenue agent restore the taxpayer to the correct method of accounting by implementing I.R.C. § 481(a), and recouping the deferred income into the earliest open year under examination, which is the taxable year [redacted].

A copy of this memo is being sent to our National Office for their ten-day post review. We will advise you of their comments regarding this advice. In the meantime, please contact the undersigned at (415) 744-9217 if you have any questions. Thank you for your assistance.

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